Private Governance and Unsecured Loans

By Edward Peter Stringham The Conversation October 29, 2015

What are the limits of private governance? I very much appreciate Mark Lutter's praise for my book and his critical discussion.

Lutter writes: "While I would strongly recommend the book, I will take this essay to delineate how far the logic of private governance can be extended, something that Stringham did not do. First, is there a set of contractual interactions to which the club good model is not easily applicable?"

Lutter describes how private governance works well when people have information about the past behavior of potential business partners. A lender can choose to make a loan to a person with a long history of paying loans and choose not to make a loan to a person with a long history of defaulting.

But Lutter suggests that when someone does not have an established reputation, formal contract enforcement is the only real solution for securing a loan. He argues that in Nigeria, banks don't want to make loans to entrepreneurs because they cannot recover damages in court. He then describes a Nigerian business competition that gave loans to a certain set of firms and ended up benefiting those firms. He argues that the good results of the experiment show that the market for private governance was not working. "This suggests the private credit market in Nigeria is deficient in ways that have a strong effect on business creation and growth."

Although I agree that the private credit market in Nigeria is much less developed than it should be, the lack of advanced mechanisms of private governance may not be due to market failure, but to longstanding government interference in the economy. In 1980, Nigeria's score on the Fraser Institute's Economic Freedom of the World list was 4 out of 10, and today it is 6 out of 10. Although I wish markets could bulldoze or ignore bad government policies wherever they exist, sometimes the bad policies are triumphant and significantly hinder markets.

Let me suggest that extractive government policies are much more of a hindrance to Nigerian entrepreneurs than government not doing a good job at enforcing credit contracts. In the United States, government policies impose many problems, but Fraser has always found the United States to have higher levels of economic freedom than Nigeria.

Yet even with better economic policies in the United States, we should not assume that successful venture capital markets are made possible because of good enforcement of contracts. We know, for example, that around 75 percent of startups fail and early investors often lose all of their money. Many belly-up firms have nothing to turn over. Moreover, most founders do not have track records running businesses as big as the founders' optimistic projects.

Despite these potential problems, all of that information goes into investors' decisions and gets priced into equity prices or interest rates for loans. Markets work so well because they let potential borrowers or recipients of investment build up a history of success, however small, to woo investors. But they also let investors take risks and give their money to less established founders, and all of that can get priced into equity shares or interest rates.

As I describe in *Private Governance*, a potential stockbroker in 17th-century Amsterdam asked others how he would be allowed to get into in the market without a credit history. Others tell him that he should start small with low risk options and then he can expand as his reputation grows. The same is true with modern lending. Few banks will give a recent high school graduate $250,000 to buy a house, but most banks are

willing to offer a credit card with a $250 credit limit and see whether the borrower pays back his loan. Only later will a bank offer a larger loan, such as for a car or other higher value purpose.

Because loans to entrepreneurs and many other loans are unsecured, the lender does not really have an option of recovering funds in even the most efficient court. Nevertheless, markets for unsecured loans exist and quite often thrive.